

NO.: **IT-96R6**

DATE: October 23, 1996

SUBJECT: **INCOME TAX ACT**

**Options Granted by Corporations to Acquire Shares, Bonds, or Debentures and by Trusts to Acquire Trust Units**

REFERENCE: Paragraphs 49(1)(b) and (c) (also sections 7, 51, and 77; subsections 15(1), 49(2), 49(2.1), 49(3), 49(3.01), 49(3.2), 49(4), 49(5), 52(1), and 212(2); paragraphs 53(1)(j), 53(2)(g.1), and 214(3)(a); and subparagraph (b)(iv) of the definition of “disposition” in section 54)

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## ***Application***

This bulletin cancels and replaces Interpretation Bulletin IT-96R5 dated May 13, 1991.

## Summary

This bulletin deals with the income tax treatment of amounts paid or received for the granting and exercising of options on capital account. Three types of options are discussed:

- an option a corporation grants entitling the holder to acquire shares of its capital stock, bonds, or debentures that the corporation will issue;
- an option a trust grants entitling the holder to acquire units of the trust that the trust will issue; and
- an option a corporation grants entitling the holder to acquire securities of another entity.

There are generally no tax implications to the grantor or the holder of either of the first two types of options until the option is exercised, disposed of, or expires. On the other hand, when the third type of option is granted, the grantor is considered to have disposed of property and a gain would be realized by the grantor.

Employee stock options, although granted by a corporation on its own securities (or on securities of a non-arm's length corporation), are not the subject of this bulletin (see the current version of IT-113, *Benefits to Employees – Stock Options*).

## Discussion and Interpretation

### GRANTING AN OPTION

¶ 1. Generally, subsection 49(1) provides that for the purposes of the capital gains and losses rules in subdivision c of division B of the *Income Tax Act*, the granting of an option is a disposition of a property the adjusted cost base of which to the grantor immediately before the grant is nil. However, paragraphs 49(1)(a), (b), and (c) except the following types of options from this rule:

- an option to acquire or to dispose of a principal residence (see the current version of IT-120, *Principal Residence*);
- an option granted by a corporation to acquire shares of its capital stock, bonds or debentures that the corporation will issue; or
- an option granted by a trust after 1989 to acquire units of the trust that the trust will issue.

### OPTION TO ACQUIRE THE GRANTING CORPORATION'S OWN CAPITAL STOCK, BONDS, OR DEBENTURES

¶ 2. Subject to ¶ 3 below, if a corporation grants an option described in paragraph 49(1)(b), the granting of the option does not usually result in any income tax consequences for the grantor or the holder of the option. A corporation often grants such an option in the form of a right or warrant, separate and detachable for trading purposes from any other security of the corporation. However, paragraph 49(1)(b) does not apply to options that a non-corporate taxpayer grants, or to options that a corporation grants to acquire another entity's shares, bonds, or debentures.

## Shareholder benefit

¶ 3. Unless all owners of the common shares of a corporation's capital stock are granted rights to acquire shares of the corporation's capital stock, the granting of an option to a shareholder may give rise to a taxable benefit under subsection 15(1) (see the current version of IT-116, *Rights to Buy Additional Shares*). For options granted after December 19, 1991, the corporation must grant identical rights at the same time to all owners of common shares in respect of each common share they own for subsection 15(1) not to apply.

For example, when a corporation, for **no consideration**, grants on only some of its common shareholders, rights to purchase any additional shares of the corporation's capital stock, subsection 15(1) applies to those shareholders. A taxable benefit under subsection 15(1) may also arise when a corporation grants to a non-shareholder an option to acquire shares in the corporation. Normally, the amount of a benefit under subsection 15(1) is the greater of:

- the trading value of the rights received; and
- the amount by which the fair market value of the shares subject to the option at the time of the option's distribution exceeds the exercise price provided in the option.

The amount of such a benefit is added to the cost of the rights under subsection 52(1) except to the extent that the amount is otherwise added to the cost, or included in calculating the adjusted cost base, of the rights to the shareholder. For a non-resident shareholder, paragraph 214(3)(a) provides that the amount of the benefit is deemed to have been paid as a dividend from a corporation resident in Canada, and it is therefore subject to income tax under the provisions of subsection 212(2).

## Expiry of an option

### Grantor's position

¶ 4. When an option described in paragraph 49(1)(b) that was granted after 1971 expires, the granting corporation is deemed by subsection 49(2) to have disposed of capital property for proceeds equal to the proceeds the corporation received for granting the option. Subsection 49(2) further deems the adjusted cost base of that capital property immediately before the disposition to be nil. Accordingly, the proceeds from granting the option are treated as a capital gain in the year the option expires. Subsection 49(2) does not, however, apply in the case of an option to acquire shares of a corporation's capital stock in consideration for the option holder incurring expenses pursuant to an agreement described in:

- paragraph (e) of the definition of "Canadian exploration and development expenses" in subsection 66(15);
- paragraph (i) of the definition "Canadian exploration expense" in subsection 66.1(6);
- paragraph (g) of the definition "Canadian development expense" in subsection 66.2(5); or

- paragraph (c) of the definition “Canadian oil and gas property expense” in subsection 66.4(5).

### ***Holder’s position***

¶ 5. Because subparagraph (b)(iv) of the definition of “disposition” in section 54 includes the expiry of an option, the holder of an option is considered to have disposed of the option when the option expires. The holder has no proceeds of disposition and a capital loss usually results to the extent of the adjusted cost base of the option at the time it expires.

### **When option exercised**

#### ***Grantor’s position***

¶ 6. The granting corporation is not subject to tax on the proceeds from granting an option to acquire shares of the corporation’s own capital stock, bonds, or debentures when the holder exercises the option. When the option allows the holder to acquire shares in the capital stock of the granting corporation, the amounts received on the exercise of the option will usually form part of the corporation’s paid-up capital of that particular class of shares to which the option pertains (see the current version of IT-463, *Paid-Up Capital*). Similarly, if the option allows the holder to acquire bonds or debentures of the granting corporation, the amounts received on the exercise of the option form part of the corporation’s surplus.

#### ***Holder’s position***

¶ 7. Paragraph 49(3)(b) generally provides that when an option is exercised, the holder adds the adjusted cost base of the option to the cost of the property acquired. However, subparagraph 49(3)(b)(i) provides an exception for options exercised after July 13, 1990, when the property the holder acquired on the exercise of the option is a share and the adjusted cost base to the holder has been increased under paragraph 53(1)(j) because of the application of section 7 to a person who did not deal at arm’s length with the holder (see the current version of IT-113). Subparagraph 49(3)(b)(i) ensures that there is no duplication of additions to the adjusted cost base of a share in these situations.

For taxation years ending after February 21, 1994, a person who exercises an option to acquire specified property (as defined in section 54 as a capital property that is a share, a capital interest in a trust, a partnership interest, or an option to acquire such a property) may be required to deduct from the adjusted cost base of the specified property amounts that had been deducted under paragraph 53(2)(g.1) when calculating an option’s adjusted cost base. However, a corresponding increase in the adjusted cost base of the specified property is also provided under subsection 49(3.01) so that there is no net effect on the amount of the adjusted cost base of the property. Subsection 49(3.01) effectively preserves the history of deductions when calculating the adjusted cost base of an option under paragraph 53(2)(g.1), which relates to reductions in the adjusted cost base arising from the operation of the debt-forgiveness rules. The only

relevance of subsection 49(3.01) is with respect to the potential future application of section 80.03 which applies where capital property that is a share (other than a distress preferred share), partnership interest or trust interest is surrendered.

### **Option Issued Concurrently with Another Security**

¶ 8. If a corporation issues an option concurrently with another security, the grantor must make a reasonable allocation of the issue price and any expenses of issue between the option and the security. Similarly, the holder must make a reasonable allocation of the purchase price and applicable expenses between the option and the security.

### **Security with a conversion feature**

¶ 9. In the case of a security with a conversion feature which is not severable from the security and cannot be separately traded, no part of the issue price can be allocated to the conversion feature. If the security is converted, the proceeds of disposition cannot be allocated between the conversion feature and the security. Therefore, section 49 does not apply to such a convertible security. A “convertible security” includes a security to which section 51 applies or, for exchanges occurring before November 1994, a security to which section 77 applies.

### **Sale to a third party**

¶ 10. The sale or other disposition of an option by the holder to a third party is a disposition of property from which a gain or loss may result. However, it does not affect the tax position of the corporation or trust which originally granted the option.

### **OPTION TO ACQUIRE THE GRANTING TRUST’S OWN UNITS**

¶ 11. When a trust grants an option described in paragraph 49(1)(c) after 1989, there are no tax consequences to the grantor or to the holder. However, when such an option expires, the granting trust is deemed by subsection 49(2.1) to have disposed of capital property for proceeds equal to the proceeds it received for granting the option. Subsection 49(2.1) further deems the adjusted cost base of that capital property immediately before the disposition to be nil. Accordingly, the proceeds from granting the option are treated as a capital gain in the year in which the option expires. As described in ¶ 5 above, when an option expires, the holder is considered to have disposed of the option. This will usually result in a capital loss to the extent of the adjusted cost base of the option at the time of expiry. However, under subsection 49(3), when a person acquires a property as a result of the exercise of an option, the adjusted cost base of the option will be added to the person’s cost of the property acquired.

## OPTION TO ACQUIRE SECURITIES OF ANOTHER ENTITY

The discussion in ¶s 12 to 17 below deals with the income tax treatment of options other than those described in paragraphs 49(1)(a), (b), and (c).

¶ 12. When paragraph 49(1)(a), (b), or (c) does not apply, the grantor of the option is considered to have disposed of a property at the time the option was granted. Under subsection 49(1), the adjusted cost base of the property to the grantor immediately before the grant is nil. Therefore, the grantor will realize a capital gain equal to the proceeds of disposition of the property less any expense of issue.

### Cost of the option

¶ 13. The cost of an option to a holder is the consideration that the holder pays to the grantor for the option, plus applicable expenses. If an option expires, the holder is deemed by subparagraph (b)(iv) of the definition of “disposition” in section 54 to have disposed of the option at that time and a capital loss usually results to the extent of the adjusted cost base of the option. The sale or other disposition of an option by the holder to a third party is a disposition of property from which a gain or loss may result. The grantor’s tax position is not affected if the option expires or if the holder sells the option.

### When option exercised

#### *Grantor’s position*

¶ 14. Subject to the election described in ¶ 15 below, when an option is exercised, subsection 49(3) applies and the grantor is no longer considered to have disposed of the option in the year in which it was granted. The grantor may file an amended tax return for that year excluding from income the deemed gain on the option (see the current version of IT-384, *Reassessment Where Option Exercised in Subsequent Year*). A reassessment will be made accordingly if the requirements of subsection 49(4) are met. Under subsection 49(3), the grantor’s proceeds of disposition of the property disposed of by the exercise of the option include the proceeds the grantor received for granting the option.

¶ 15. An individual (other than a trust) who has granted an option before February 23, 1994 and who disposes of property after February 22, 1994, as a result of the exercise of the option, may elect under subsection 49(3.2) not to have the provisions of subsection 49(3) apply. The effect of this election is to allow the gain that arose upon granting the option to remain eligible for the \$100,000 lifetime capital gains deduction, which was eliminated for gains realized on dispositions that occur after February 22, 1994. Under subsection 49(3.2), the election would be made in the individual’s return of income for the taxation year in which the disposition occurs.

#### *Holder’s position*

¶ 16. Paragraph 49(3)(b) generally provides that when an option is exercised, the holder adds the adjusted cost base of the option to the cost of the property acquired. However, see ¶ 7 above for comments on the exception in subparagraph 49(3)(b)(i) for certain options exercised after July 13, 1990.

### Anti-avoidance provisions

¶ 17. When a taxpayer grants an option to a person with whom it does not deal at arm’s length on capital account to acquire securities of another entity, section 69 may be applied to the disposition of the securities if the price of the option and the exercise price are materially less than the fair market value of the securities otherwise determined at the time of the exercise of the option. The application of section 69 will most often apply when the taxpayer has granted a non-arm’s length “non-commercial option.” A “non-commercial option” is one into which arm’s length parties would not consider entering. For example, this type of option may involve an unrealistically long option period, a low option price, or an exercise price that does not fully recognize expected future events (e.g., inflation, zoning change, market trends) that affect the value of assets owned by the corporation whose securities are being optioned and thus which affect the price of the optioned securities over the option period.

### Extension or Renewal of Options Granted

¶ 18. When a grantor extends or renews an option to which subsection 49(1), (2), or (2.1) applies, the provisions of subsection 49(5) apply. Under that subsection, each extension or renewal is deemed to be the granting of an option when the extension or renewal is granted. The original option and each extension or renewal of the original option is deemed to be the same option for purposes of subsections 49(2) to (4), and subparagraph (b)(iv) of the definition “disposition” in section 54. Each year of extension or renewal is an initial year for purposes of subsection 49(4). As a result:

- each extension or renewal of an option to which subsection 49(1) applies is treated as described in ¶ 12 above;
- subsections 49(2) and 49(2.1), and subparagraph (b)(iv) of the definition “disposition” in section 54 (see ¶s 5, 11, and 13 above) do not apply until the last extension or renewal has expired;
- if the holder exercises the option, subsection 49(3) (see ¶s 7, 11, and 14 above) applies at that time on the basis that the original option and all extensions or renewals are one option; and
- subsection 49(4) (see ¶ 14 above) may be applied to each year for which the original option or an extension or renewal was granted.

## *Explanation of Changes*

### Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental positions.

### Overview

This bulletin discusses the income tax treatment of amounts paid or received for the granting and exercising of options on capital account. We have revised this bulletin to incorporate the amendments to the *Income Tax Act* enacted by: S.C. 1994, c.7, Schedule II (1991, c.49 – formerly Bill C-18), S.C. 1994, c.7, Schedule VIII (1993, c.24 – formerly Bill C-92), S.C. 1995, c.3 (formerly Bill C-59), and S.C. 1995, c. 21 (formerly Bill C-70).

The contents of this bulletin are not affected by any draft legislation released prior to August 12, 1996.

### Legislative and other changes

New ¶ 1 was added to explain the general rule under subsection 49(1) that provides that the granting of options other than those described in paragraphs 49(1)(a), (b), and (c) are dispositions of property.

¶ 3 (former ¶ 2) discusses the tax consequences arising from the application of subsection 15(1) when a corporation grants an option and confers a benefit on a shareholder. We have revised this paragraph to reflect the amendment to paragraph 15(1)(c) requiring the corporation to grant **identical** rights to acquire additional shares of the capital stock of the corporation to all owners of common shares in respect of each common share they own, in order for the value of the option not to be included in the option holder's income. We have also revised this paragraph to reflect the amendment to subsection 52(1) which ensures that the amount of a benefit under subsection 15(1) that is added to the cost of the option is limited to the amount of the benefit that has not otherwise been added to its cost or included in computing its adjusted cost base.

¶ 4 (former ¶ 3) discusses the grantor's position when an option expires. It deals with subsection 49(2) and has been revised to reflect the changes to the references to other provisions of the *Income Tax Act*.

¶ 5 (former ¶ 3) discusses the holder's position when an option expires. It has been revised to reflect an amendment that has replaced former clause 54(c)(ii)(D) with subparagraph (b)(iv) of the definition of "disposition" in section 54.

New ¶ 7 has been added to describe the provisions of paragraph 49(3)(b) that deal with the adjusted cost base of the shares acquired as a result of the exercise of an option. In addition, the provisions of subsection 49(3.01), which deal with an option that is exercised to acquire specified property, are discussed.

¶ 9 (former ¶ 6) has been revised to reflect the repeal of section 77 applicable to exchanges occurring after October 1994.

New ¶ 11 was added as a result of the introduction of paragraph 49(1)(c). It deals with the exception from the general rule in subsection 49(1) for options that a trust grants to acquire units of the trust that the trust will issue. It also discusses the provisions of subsection 49(2.1) that apply when the option expires.

¶ 13 (former ¶ 9) has been revised to reflect the amendment that has replaced former clause 54(c)(ii)(D) with subparagraph (b)(iv) of the definition of "disposition" in section 54.

New ¶ 15 explains the election available under subsection 49(3.2).

New ¶ 16 has been added to describe the provisions of paragraph 49(3)(b) that deal with the adjusted cost base of the shares acquired as a result of the exercise of an option.

¶ 17 (former ¶ 11) has been revised to reflect our position that section 69 rather than subsection 245(2) may apply to the disposition of securities of another entity under a non-arm's length option if the price of the option and the exercise price are materially less than the fair market value of the securities otherwise determined at the time the option is exercised. We have also deleted the comments relating to subsection 55(1) as that subsection was repealed with respect to transactions entered into on or after September 13, 1988.

¶ 18 (former ¶ 12) describes the provisions of subsection 49(5) that apply when options are extended or renewed. It has been revised to reflect amendments to that subsection stemming from the introduction of paragraph 49(1)(c) and subsection 49(2.1). We have also revised this paragraph to reflect the amendment that has replaced former clause 54(c)(ii)(D) with subparagraph (b)(iv) of the definition of "disposition" in section 54.

Throughout the bulletin, we have made a number of changes to improve the clarity and readability of the bulletin.

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